TSL
FEATURE

Winter Is Coming:

What We Learned About Preparing for a Cooling Economy

BY CHRIS GOUSKOS

The latest South Florida SFNet chapter event on September 17, "Winter is Coming: How to Prepare for a Cooling Economy," was an in-depth panel presentation moderated by Chris Gouskos from Gibraltar Business Capital. The panelists shared practical ways lenders can protect their institutions and their clients as economic uncertainty builds. Together, they examined how deals are originated, managed, and, when necessary, restructured.

“It has been since the Great Recession that we have had a real economic cycle,” began Gouskos as he framed the issue. “In response to the COVID epidemic, the government pumped so much money into the system that most companies and the economy at large avoided significant economic impacts. There were unintended consequences, supply chain issues and inflation to contend with, but the economy kept rolling along. Now we have tariffs that go up and down and a lot of uncertainty around their implementation and effect. The impact on company financial performance and collateral valuation remains uncertain, leaving business owners, management teams and lenders in a somewhat tenuous position. It’s critically important to make sure as senior lenders that we are proactive from an underwriting, portfolio management, collateral management and reporting perspective.”

In addition to Gouskos, the panel included Mark Smith, head of underwriting for Regions Business Capital; David Montiel, who oversees White Oak Commercial Finance’s special assets; Stan Grabish with GA Group’s field exam team; Joe Massaroni, representing Gordon Brothers’ Appraisal Group; and Mike Litwack, who is a turnaround professional with Richter Consulting. Panelists explored five main areas: structuring new deals, portfolio management, spotting early warning signs, and acting when trouble surfaces and general economic conditions and potential tariff impacts on profitability and collateral values.

Structuring New Deals

The conversation began with what makes the most sense to do in this environment from a new business perspective. Investment committees will be tighter on credit when the economy contracts and will have many more questions, but all agreed that in uncertain times, lending must continue.

Smith began by stating, “I start every diligence process with understanding how I can get our institutions’ and stakeholders’ money back. I can promise you in my shop we’re getting a lot tougher questions from our credit officers and we’re asking tougher questions of our clients. So, I would say the first thing to do is really heighten your diligence. We understand we’ve got to work with clients and we’re not there to offend them or accuse them. But dig down. Be careful not to accept superficial answers that you can’t somehow support. So ask why, why, why and really search for the answer.”

The second point made by the panel is to make sure to thoroughly read the collateral appraisals thoroughly and slowly. It’s very important to understand and agree with critical assumptions. Don’t just look at the NOLV page. Make sure to analyze it. They’re a tool, not a guarantee.

Lastly, existing in a world of springing cash dominion, springing covenants and other “big deal” terms that have

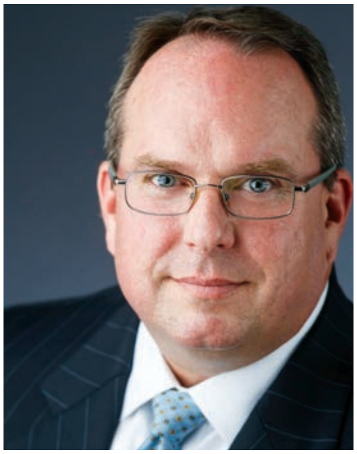
CHRIS GOUSKOS
Gibraltar Business Capital

STAN GRABISH
GA Group

MIKE LITWACK
Richter Consulting

JOE MASSARONI
Gordon Brothers

DAVID MONTIEL
White Oak
Commercial Finance



MARK SMITH
Regions Business Capital

matriculated in the middle and lower middle market, make sure to have ways to protect your position if performance deteriorates. Ensure triggers are set at levels that trip while there is adequate liquidity and room to maneuver. Also make sure to never give up the ability to establish reserves, even if they are slightly diluted with "commercially reasonable" language. The sooner you can get a weak borrower to the table, the better off you will be.

Macro-Economic Signs of Softening and Bell Weather Industries

What indicators should be watched for and what industries typically act as early warning signs of a weakening economy?

There are macro-economic indicators that all lenders track, including unemployment rates, wage growth, job creation, the PMI and housing starts to name a few. In addition, there are certain bellwether industries that provide early signals as well:

- Transportation has historically been a good indicator of economic conditions. Specific COVID and post-COVID supply and demand imbalances at the asset level have caused the transportation industry to underperform for quite some time now, making it less reliable as an early indicator.
- Aluminum, as a primary commodity that goes into almost everything that is manufactured these days, can be an early indicator of demand. However, this has also been skewed in the current environment with prices close to a three-year high due to supply constraints driven by China's production cap coupled with falling inventory levels. Lingering supply chain issues and a weaker dollar have also contributed to aluminum's higher prices.
- Retail sales growth is another indicator. In the first half of 2025, retail sales growth was steady, but has since cooled. There are questions about how much of this activity is due to "pull forward" demand driven by buying ahead of tariff implementation.
- Lastly, the strength of the consumer is something to watch closely. With average credit card balances being at a four-year high and average FICO scores dropping for the first time since the Great Recession, consumer strength is appearing to come into question. Weaker jobs reports have to be considered as well when underwriting new business and evaluating portfolio companies.

"We recently came across several instances where the borrowing base spreadsheets we were reviewing had mapping and/or formula flaws that swung the true availability levels by millions of dollars in both directions. It is critical that the BBC spreadsheets be periodically reviewed and vetted," cited Grabish.

None of this should be assessed in a vacuum and each case is unique. The panelists stressed the importance of understanding what economic factors and drivers can either directly impact the performance of a prospect or portfolio account or are highly correlated.

Managing Existing Portfolios

What can we do as investment professionals to make sure we are on top of what is happening throughout the portfolio?

"Simplistically, you can categorize credits as green, yellow, and red," Montiel observed. "The greens, they're fine. They're profitable, they have adequate liquidity. The reds are already workouts you're probably trying to exit or are in liquidation. But the yellows are the ones that can go either way. We focus on those and identify what are the events or the triggers that could move this company in one direction or another?"

It is always critical to evaluate various exit strategies and levers that can be pulled to improve one's position. Other fundamental moves include making sure collateral and financial reporting is being received on a timely and accurate basis, performing more frequent internal credit reviews, and having more frequent borrower conversations and site visits.

Many on the panel stressed the importance of getting "boots on the ground" and walking through production facilities and warehouses, allowing for time to ask deeper and more probing questions. All of these activities stress the importance of being in front of your customers, getting a little closer to them, doing more diligence, drilling down, not accepting pat answers, and really getting into your collateral at a granular level. To the extent possible, increasing appraisal and audit frequency should also be considered as well as implementing discretionary reserves early, before liquidity dries up.

The bottom line is to make sure lenders have the internal processes and procedures in place to track and monitor clients' financial and collateral performance on a timely basis and to act as quickly as possible when they deteriorate. Again, the sooner a lender can get a borrower to the table, the better off all parties will be.

Early Warning Signs: Financial Performance and Collateral Analysis

Asset-based lenders are classically trained to focus on liquidity and working capital performance. Excess availability, or what is left after all the other activities take place, is the proverbial "cash box" for asset-based lenders. Accounts receivable, inventory and accounts payable turnover along with aging trends are all used to track performance. While it is critical to be tracking these metrics, what else can be done to get even earlier indications of performance weakness?

Sales levels and gross margin tracking are obvious, but it's important to understand the drivers that are pushing these in either direction. Sales contractions are not necessarily bad if the result is to improve gross margin. Gouskos cited seeing companies in the past doing product line profitability analysis and in effect "firing" the bottom 20% of their customers because the companies were not making enough money on those relationships. The result was both improved margins as well as some working capital contraction.

Refocusing attention on a company's top ten customers and vendors is important and requires deep knowledge of each from both a financial performance perspective as well as at the contractual level with a borrower. Are key contracts about to be up for renewal? Are the contracts on a fixed price or cost-plus basis? Are key relationships stable?

The panel cautioned on not just focusing on income statements when sometimes a balance sheet is the best place to hide problems. Are there swings in accruals. Is there deferred revenue and/or deferred expenses?

"A lot of questionable behavior can get buried in a balance sheet," Litwack added. "This means getting down to the trial balance level to make sure certain account activity was just not renamed or remapped to obfuscate what is really going on."

Curtailed spending on CAPEX can also be an early warning sign of issues. Management teams may be portraying a positive outlook, but if they are cutting back on critical capital maintenance, they may be thinking differently. If a borrower's business is reliant on equipment performance and operating efficiencies that are heavily tied to lines running almost full time, cutbacks in required CAPEX can have devastating consequences.

"We've had a few instances in transportation where there was no maintenance being performed," Massaroni shared. "When our folks went out there, there were more disabled vehicles than there were operating vehicles."

This granular approach also applies to the collateral side of the equation. It is important from a reporting basis that what is submitted is timely and accurate, including borrowing base certificates and availability calculations. Over the years, borrowing base certificates and the spreadsheets used to calculate availability have become increasingly complex. Sometimes they deal with multiple legal borrowing entities, legal jurisdictions, various caps on collateral buckets and can even contain multiple currencies.

"We recently came across several instances where the borrowing base spreadsheets we were reviewing had mapping and/or formula flaws that swung the true availability levels by millions of dollars in both directions. It is critical that the BBC spreadsheets be periodically reviewed and vetted," cited Grabish.

Inventory mix is also critical to track given inventory appraisals are performed at a specific point in time. As noted by the panelists, they are a tool, not a guarantee, so tracking the key value drivers that are outlined in the appraisal remains vital. One tactic is connecting regularly with appraisal professionals to understand what is currently going on in a specific industry or collateral type. It's likely that there will be some contraction in NOLVs if a company is materially underperforming that could be driven by overall industry softness, specific borrower-related challenges or, as is often the case, caused by both.

"We went into a company that had reduced higher-than-necessary inventory levels by over 40%. At surface level, it appeared things were getting better," shared Massaroni. "At a deeper level, we found they sold off all their 'A' products because their vendors shut them off. So, we're sitting here with all the 'Ds' right now, which are worth 20 cents, not the 60 or 65 cents that the 'As' and 'Bs'were worth. So that inventory mix created a sizable hole in a borrowing base that already was showing limited availability."

Of course, the quality of management teams and ownership get put under a microscope when times get tougher and it is appropriate to press them for answers as well as solutions. Are they taking appropriate actions? Are they cutting back on SG&A to keep it in line with current revenue levels? Are they looking at product line profitability? Are they talking with their customers and vendors on a regular basis? Are they looking for ways to reduce working capital levels? What are they doing to improve cash flow and liquidity?

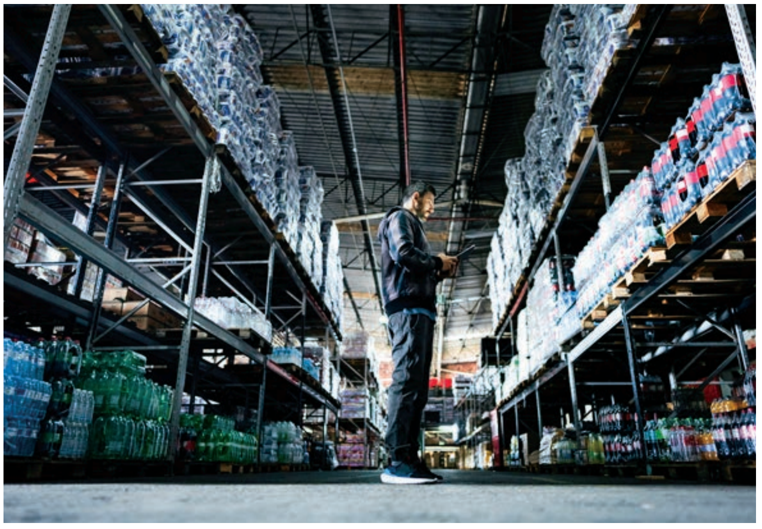
The group stressed the need to understand the root causes behind warning signs and not be appeased by surface-level explanations. Panelists cited examples of companies selling off their best products or burying liabilities in balance sheet accounts, both of which can distort borrowing bases and hide trouble until it is too late. All agreed that increasing the frequency of appraisals and field exams when warning signs appear is essential, even if borrowers resist the effort or the cost.

Acting When Trouble Surfaces

Despite best efforts, some credits fail. At that point, the timing of bringing in third-party professionals is important. The panel of experts counseled the audience to engage advisors early, review loan documents with counsel, and prepare for both restructuring and potential liquidation.

"The time to bring in an advisor is when management cannot answer basic questions," stressed Litwack when discussing critical metrics. "An unwillingness or inability to explain rising payables or disappearing cash is the clearest signal that you need additional horsepower."

Lenders are much more likely to work with borrowers when all are on the same page and there is mutual recognition that there are issues to address. The decision to hire a financial advisor does not need to be acrimonious. In those cases, it is normal to make introductions to three trusted advisors that the company could hire directly. Sometimes this can even be done in conjunction with a forbearance agreement if there are defaults.



Some companies bought as much pre-tariff inventory as possible to create a lower-cost stockpile to allow them time to figure out how to transition and "cost share" higher-priced inventory with their customer and vendors. Across the panel, consensus was that most pre-tariff inventories have been burned off and reality is about to kick in.

While lenders do their best, situations where borrowers run out of cash and options are limited, it does unfortunately happen. In these instances, the lender can hire a CRO directly as they evaluate a very different course of action, including considering out-of-court and in-court methods of restructuring, sale or liquidation of the business.

Consistent with one of the overall themes, Litwack added, "The earlier the lender takes action, the higher chance that there's adequate time for an advisor to get you an answer before it becomes a problem which can't be fixed, right?"

It was also recommended to have outside counsel do a full document file review to ensure there are no holes from a documentation perspective as well as ensure knowing exactly what our rights and remedies are.

Tariffs

Of course, tariffs were part of the discussion. The panel agreed tariffs have already begun to reshape borrower decision making and performance and are also having collateral implications.

A number of panelists noted that they are starting to see portfolio companies that were outperforming their plan start to lose steam because of difficulty understanding the impacts of tariffs along with some of their assumptions being off target. Some have seen companies become a bit paralyzed or slowed because they don't have adequate visibility into potential tariff impacts while others have witnessed reduced levels of spending on growth CAPEX.

Some companies bought as much pre-tariff inventory as possible to create a lower-cost stockpile to allow them time to figure out how to transition and "cost share" higher-priced inventory with their customer and vendors. Across the panel, consensus was that most pre-tariff inventories have been burned off and reality is about to kick in.

Tarriff-impacted inventory also has borrowing base implications. The tariff inflates the cost of the inventory which asset-based lenders may be lending against, at a "pre-tariff" appraised NOLV %. The NOLV % will most likely be impacted by the post-tariff cost which could cause some exposure. It is vital that lenders understand the impact of tariffs on clients' inventory values and the impact on the NOLV % by talking with appraisal firms.

Key Takeaways for Lenders

- Dig down deeper at the front end. Don't accept superficial answers. Keep asking why, why, why?
- Read the entire collateral appraisals. Make sure you understand and agree with the assumptions. Look at the key things to monitor and make certain you are doing it. Appraisals are a tool, not a guarantee.
- Make sure you have triggers and covenant levels set high enough to give adequate cushion to get stakeholders to the table while there is adequate excess availability and room to maneuver. Don't ever give up discretionary reserve language.
- Determine what economic indicators have correlation to your borrower's financial and collateral performance and track them.
- Make sure your portfolio management team and tools are up to the task and doing all of the basic blocking and tackling. Confirm reporting is current and financial and collateral performance trends are being analyzed. Have more frequent difficult discussions with your borrowers. Get out and do site visits. If able to do so, increase appraisal and audit frequency. Make sure your borrower has a plan to improve performance and cash flow.
- Focus on both the income statement and the balance sheet. Negative trends can be buried in the balance sheet and optics can be manipulated. Again, don't settle for superficial answers and dig down to confirm what you are being told.
- Look at CAPEX levels to make sure operating equipment is being properly maintained. Shutdowns can be extremely costly for manufacturers and other types of equipment operators.
- Make sure to thoroughly review the borrowing base model periodically to ensure it is correct. Test the roll up and all the formulas involved.
- Track collateral at a granular level. Make sure any shift in the mix is monitored and all reporting is being closely reviewed. If you have questions, call your favorite appraisal firm.
- Evaluate the management team and the ownership. Is management adequately addressing weaknesses? Do they have a supportable remediation plan? Have they been able to execute on planned objectives? Are they transparent and trustworthy? Is ownership supportive and transparent?
- Don't wait to act. Addressing issues quickly and thoroughly will pay dividends for all parties. If deemed necessary and there is a spirit of concern and cooperation with a borrower, bring in third party assistance to address issues outside of management's bandwidth or capabilities. If you have defaults, you can use a forbearance agreement to induce a reluctant borrower to bring in additional support.
- Make sure to understand how tariffs are going to impact a prospect or borrower. Understand input costs and how they will impact key customers and suppliers. Understand inventory cost and borrowing base impacts on tariff inflated inventory values relative to current NOLVs. Ask management teams how they plan to address any tariff-related challenges. They should be able to share both what they think the impact will be as well as what they plan to do about it.

Lenders who strengthen underwriting, stay close to borrowers, monitor collateral carefully, set early reserves, and bring in advisors when answers fall short will protect their capital and give borrowers the best chance as Winter arrives. As we all know, Winters never last forever.

Chris Gouskos is an SVP of Originations for Gibraltar Business Capital covering the Southeast and South-Central US. He is a seasoned finance professional with over 30 years of experience spanning cash flow and asset-based lending, consumer finance, capital markets, and credit management. He has built and led ABL platforms at Conseco Finance and Textron Financial, managed FDIC contracts at Focus Management Group, and held various roles at GE Capital, Bank of America, and Heller Financial. Prior to joining GBC, Gouskos was with White Oak for over 9 years, originating cash flow and ABL transactions. Chris holds a BBA in accounting from Iowa State University, had earned his Series 7 and 63 licenses, and is a certified Six Sigma Green Belt.